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NSC FOR RHUNTER, JSHRIER, DWILDER
USDOE for DOE OIC DPUMPHREY, OFFICE OF THE SECRETARY for
MWILLIAMSON
TRESURY FOR OASIA/ISA ADAMS/DOHNER/CUSHMAN
USDOC FOR 4220/ITA/MAC/CMMCQUEEN/HAMROCK
USDOC FOR 1003/ITA/OUS/OC
USDOC FOR 6310/ITA/TD/OIEM/KMURPHY/HBURROUHGS
UDDOC FOR 6000/ITA/TD/RPACE
EPA FOR INTERNATIONAL/AYRES, FIDLER, MCASKILL
HHS FOR STEIGER, ELVANDER AND BHAT

E.O. 12958: N/A
TAGS: ENRG PREL ETRD SENV TRGY CH
SUBJECT: CHINA/COAL: VISIT TO SHANXI PROVINCE MINE BRINGS ISSUES TO THE SURFACE

Summary

¶1. (SBU) Coal is likely to provide 65 to 70 percent of China's energy needs for at least the next 20 years, according to industry estimates, yet the sector itself faces widespread challenges related to transportation, industry restructuring, profitability, and safety. All of these problems were on display, or came up for discussion, during Econoffs' recent visit to a large coal company in Shanxi Province. Company officials said their ability to generate profits is compromised by the requirement to provide social services for over 250,000 workers and dependents. They described extensive transportation bottlenecks as they work towards doubling output over the next five years. They also complained about unfairness in who gains from coal extraction, alleging that downstream consumers, such as power companies, use their influence to capture returns that should go to miners who toil in dangerous conditions. This view was partly contested by two industry observers based in Beijing. End Summary.

Coal Mine Visit Background

¶2. (SBU) In late November 2006, Econoff and Embassy Labor Officer visited the Yangquan Coal Industry Group Company (YCG) in Shanxi Province to tour a company coal mine and meet with YCG and Chinese Government officials. Emboffs toured YCG's Xinjing mine which participates in a United States Department of Labor (USDOL) mine safety management and training project. Additionally, Emboffs visited an underground mine safety training center, toured other facilities at the Xinjing mine, and held broad ranging mine safety and coal sector discussions with YCG and Chinese Government officials. (Note: Please see septel for information relating to YCG's participation in the USDOL mine safety program. End Note.)

YCG: Impressive Production and Sales Statistics...
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¶3. (SBU) YCG is a large state-owned enterprise (SOE) comprised of more than twenty separate companies, including one publicly listed on the Shenzhen and Shanghai bourses. Individual companies within the group are involved in the coal, electricity, aluminum, and property construction and development sectors. The company's seven operational mines in 2005 had a combined output of 30.8 million metric tons of coal. Company officials stated their goal is to double coal output in the next five years. YCG had sales revenues topping one billion USD in 2005 and the company expects to triple its sales revenue within the next ten years.

...Resulting from a Commodities Based Business Plan...
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¶4. (SBU) Company officials stated that over the past several years, YCG has gone from being strictly in the coal mining business to becoming a commodities company. The company recognizes that by using more advanced technology and management techniques it can differentiate its coal product streams. This approach allows YCG to separate more valuable coal products, such as blast furnace coal, from lower-grade and lower-cost coal, such as that used for heating purposes. Company officials stated that this transition has increased the company's profitability and justifies ongoing company spending on technology and training.

¶5. (SBU) Company officials said that they plan to expand productivity and improve worker safety through adoption of the latest mining technology. As an example of the technology investments the company is making, YCG officials gave Emboffs a tour of the Xinjing mine's operations center. The computerized operations center has real-time video feeds from throughout the mine, monitors environmental conditions such as methane gas levels,

and tracks the operational status of major pieces of equipment. The operations center is also testing a helmet-mounted miner location system that provides a real-time location of each working miner. (Note: A unique feature of the miner location system is its ability to differentiate Communist Party members from non-members. The system does so by the color of helmet used to display the miners' location-red helmets from Party members and black for non-members. End Note.)

...Compromised By A Legacy SOE Structure

¶6. (SBU) YCG officials stated that the company's financial success is being tempered by its requirement to provide for its large number of employees and dependants. The company has some 100,000 employees, 40,000 of whom are involved in coal mining, and is responsible for providing social services to around 250,000-300,000 workers and dependents. The company's social service responsibilities include provision of health care, housing, and primary and secondary education, according to company officials. Additionally, the company operates its own police and fire departments as well as providing some basic utility services to its employees, such as home heating and cooking gas.

Transportation Difficulties Limit Production...
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¶7. (SBU) YCG officials noted that transportation difficulties are impeding the company's coal production output. The company could safely increase its production by 20 percent if it had more transportation resources available. Company officials estimate that the company ships 75 percent of its production by truck with the remainder moving by rail. The Yangquan area has one main rail line and roadway linking it to the rest of the province. The expressway is heavily burdened with traffic and is subject to weather-related closures. (Note: On the day of Emboffs arrival in Shanxi Province, the expressway was closed for several hours due to heavy fog. End Note.) YCG officials stated that they must compete with railway passenger cars for access to the one rail line in and out of the area.

...But Officials Hopeful They Can Be Resolved

¶8. (SBU) YCG officials stated that they are hopeful that their transportation difficulties can be overcome during the next five years. The company is negotiating with Ministry of Railways to shift some passenger service away from the area to allow for more freight traffic. Company officials stated that they are working with government officials from neighboring Hebei Province, the over-road destination for much of the company's coal, to explore how to expand the capacity of the expressway connecting the two areas. (Comment: Beyond these two examples, company officials offered little insight as to how they would surmount transportation limitations while concomitantly doubling coal output during the next five years. End Comment.)

YCG: Market, Other Factors Raising Coal Prices...
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¶9. (SBU) YCG officials, in response to a question from Econoff, stated that the perception large SOE Chinese coal companies are earning too much money is ridiculous. Demand for coal in China is growing rapidly, and it is only natural that prices would rise as well, according to company officials. The officials said that more stringent environmental and work safety standards leveled on the company, along with other large state-owned mining companies, are contributing to rising prices as well. YCG and other large SOE coal producers earn around 100-120 RMB for every metric ton they produce, according to YCG officials. Small, private producers which are not making similar mine safety and environmental protection investments

are much more profitable, earning 200 RMB for every ton produced.

¶10. (SBU) We note that "small" coal mines in China are most frequently defined as those with less than 30,000 metric tons of coal production per year. In 2004, the Chinese Government estimated that there were some 23,000 small mines in China. The China Coal Industry Association estimates that small, private coal mines account for one-third of total Chinese coal output. These producers also account for more than two-thirds of China's reported coal mine accident fatalities.

...But Others Earn Too Much From Our Work

¶11. (SBU) YCG officials complained that coal mining is a very dangerous business and thousands lose their lives each year in mines, yet downstream consumers , such as power companies, have used their political and economic influence to earn large profits to ensure that their employees receive generous salaries and benefits. It is not unreasonable for coal companies to seek the same benefits, they said. Separately, a Central Government mine safety official claimed that it is well known that Chinese power companies earn too much money, much of it at the expense of coal companies, and that their employees are compensated too well for the work they perform.

Power Companies Offer Different Take on Prices
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¶12. (SBU) In a separate meeting held in Beijing, Xiao Jun, Deputy General Manager for International Cooperation at the China Huaneng Group, told Econoff that power companies' profit margins are being cut by rising Chinese coal prices. Huaneng this year threatened to buy coal from Australia when negotiating coal prices with domestic coal producers. This tactic provided some temporary leverage over domestic producers, but is not a long-term solution to rising coal costs, said Xiao.

¶13. (SBU) Dr. Chi Zhang, a power analyst with Cambridge Energy Research Associate's Beijing office, said that Huaneng's complaints result from China's regulated electricity prices not keeping pace with market-based coal prices. The Central Government in 2005 developed the "coal pass through system" in an effort to address this problem. The system is intended to allow the regulated electricity price to increase in order to pass increased coal costs to power consumers. Dr. Chi noted that the problem from the power

companies' perspective is that only 70 percent of the coal price increase can be passed to power consumers. Power generators must absorb the remaining 30 percent of the coal cost increase and this is eroding their profit margins.

YCG's Contempt Leading To Its Own Downstream Plans
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¶14. (SBU) YCG officials stated that during the nexQ years they want to expand into the power generation business. The company generates power for its own use and provides some limited resources to the local area. YCG currently uses coal to fuel its power generation plant, but expects to turn to mine-mouth gas to power the company's foray into commercial power generation, said company officials. YCG officials explained that their plan is to sell the power onto the national power grid.

¶15. (SBU) Note: China's largest coal company, the Shenhua Group, has already made this move. Shenhua will generate around 10 gigawatts of electricity at its power plants in 2006 and plans to expand its production in the coming years. Chinese power companies are also experimenting with expanding into the upstream coal mining business. The Huaneng Group owns and operates several of its own coal mines, but company executives told Econoff that so far they consider they experiment to be disappointing. End Note.

Comment: Visit Lays Bare Issues Facing Coal Sector
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¶16. (SBU) Comment: Emboffs visit to YCG highlighted many of the issues facing China's coal sector. Coal production in 2006 will top 2 billion metric tons and will be used to meet 70 percent of China's overall energy needs. Even the most optimistic forecasts have coal meeting at least 65 percent of China's energy needs for the next 20 to 25 years. The coal sector is beset with safety problems with almost 6,000 reported deaths in 2005, hamstrung by transportation woes, and is increasingly being blamed for environmental problems. Beijing's answer to these problems has been to call for greater consolidation in the sector. This should result in increased reliance on large SOE coal producers such as YCG and Shenhua. In particular, Beijing believes that its oversight over the large SOEs will allow it to enforce more stringent safety and environmental regulations.

¶17. (SBU) Based on our visit and discussions with industry representatives, it is clear that the most glaring problem with Beijing's plan is that the country's rising coal demand outstrips the ability of large SOE coal companies to make up for production lost by closing small mines while simultaneously meeting rising coal demand. Beijing's strategy also is being undermined by local governments' efforts to preserve local jobs and maintain tax revenue from small producers. It is unclear how long it will take for Beijing's consolidation plan to work, if it ever will. In the near term, the largest SOE producers will continue their march towards world-class status by becoming more technologically advanced, more efficient, and more profitable. Meanwhile, despite Beijing's efforts, China's thousands of highly profitable small-sized mines will continue Q often unsafe and environmentally unfriendly production in order to help meet China's growing demand for coal. End Comment.